KBRA KROLL BOND RATING AGENCY

U.S. Public Finance
State Rating Report

State of Connecticut

General Obligation Bonds
2014 Series E, and
2014 Taxable Series A & B

Analytical Contacts:

Kate Hackett, Managing Director
khackett@kbra.com, 646-731-2304

Alice Cheng, Senior Analyst
acheng@kbra.com, 646-731-2403

July 30, 2014

Executive Summary

Kroll Bond Rating Agency ("KBRA") has assigned a long-term rating of AA with a stable outlook to the State of Connecticut's $510.59 million General Obligation Bonds 2014 Series E and 2014 Taxable Series A & B. In addition, KBRA affirms the long-term rating of AA with a stable outlook on the State's outstanding General Obligation Bonds, excluding Bonds backed by a letter of credit or liquidity facility, unless otherwise noted. After issuance of these Bonds, the State's outstanding general obligation debt will total approximately $16.3 billion.

This rating is based on KBRA's **U.S. State General Obligation Rating Methodology**, published on March 28, 2012.

This report serves as an update to the **State of Connecticut General Obligation Bonds 2014 Series D** published on June 3, 2014. For further information and a full discussion of the Key Rating Determinants, please see this report as well as **State of Connecticut General Obligation 2012 Series A & B** report published on March 29, 2012.

Security

The Bonds are general obligations of the State and are secured by Connecticut's full faith and credit pledge. All General Obligation Bond debt service of the State is deemed appropriated without further action by the State Legislature.

Use of Proceeds

Proceeds from the 2014 Series E and 2014 Taxable Series A will be used to fund various capital projects and purposes of the State. Proceeds of the 2014 Taxable Series B bonds will be used to refund existing general obligation debt of the State. The 2014 Series E Bonds are scheduled to mature in 2034, the 2014 Taxable Series A bonds are scheduled to mature in 2024, and the 2014 Taxable Series B bonds are scheduled to mature in 2027.

Key Rating Strengths
• Current leadership has demonstrated an ability and willingness to raise revenues and adjust expenditures.
• A strong financial management framework exists for tracking revenues and monitoring budget performance.
• The State has implemented a plan for funding its accumulated GAAP deficit and converting to GAAP based budgeting as part of the FY 2014- FY 2015 Biennium Budget.
• Connecticut has the highest per capita income in the country at $61,679 as of the fourth quarter of 2013.
• Available cash balances provide good liquidity for operations, without utilization of external borrowing.
Key Rating Concerns
• Slower than expected economic recovery continues to impact revenue collection, threatening budget balance.
• Revenue base is volatile due to concentration in the financial services sector and progressive nature of the income tax structure.

- Though the State is expecting to increase the Budget Reserve Fund to an amount equal to 2% of General Fund expenditures by the end of FY 2014, this level of reserves remains somewhat low, given the relative volatility of the revenue base.
- State debt burden is high on a per capita basis and as a percentage of personal income.
- Connecticut has a high level of unfunded pension liabilities.

Rating Summary

KBRA views the State's ongoing lag in economic recovery and its impact on budgetary operations as continuing to pressure the fiscal operations of the State. The slow pace of the economic recovery, compared to the region and the nation, has created increased demand for services while some economically sensitive revenue collections, including income tax and sales tax collections, continue to be below expectations. KBRA will continue to monitor the State's consensus revenue process and its ability to accurately project estimates of income tax revenues related to the realization of capital gains and other economically sensitive revenues. KBRA expects that the State will continue to actively monitor its budget projections and act to increase revenues or reduce expenditures in order to maintain budget balance.

Based on the budgetary estimates provided by the State's Office of Policy and Management (OPM) on July 25, 2014 for the period ending June 30, 2014, the State's General Fund is projected to end FY 2014 with a surplus of $121.3 million, or approximately 1% of projected FY 2014 General Fund expenditures, which is higher than the surplus of $43.4 million projected at the time of KBRA's rating report dated, June 3, 2014. This consensus revenue forecast reflects the unanticipated slowdown in economic growth during the beginning of 2014. Pursuant to current state statute, the operating surplus of $121.3 million will be deposited to the Budget Reserve Fund, bringing the estimated balance to $392 million or approximately 2% of projected FY 2014 General Fund expenditures. Based on the July OPM report, the increase in the projected surplus is a result of a projected net increase in General Fund revenues, including Federal Grants and personal income tax collections, as well as projected lapses in appropriations.

The Office of the State Comptroller released the FY 2013 audited financial statement (CAFR) reported on a GAAP basis on February 28, 2014. For FY 2013, the General Fund ended the year with a surplus on a GAAP basis of $322.0 million and a negative unassigned fund balance (accumulated GAAP deficit) of $1.2 billion. In October of 2013, the State issued $560 million in GAAP Conversion Bonds that will amortize over 15 years, beginning in FY 2016. Net proceeds of these Bonds were deposited into the General Fund and will fund approximately 50% of the accumulated GAAP deficit and improve the State's cash position. The effect of this deposit was to reduce the negative unassigned fund balance to approximately $618 million. The remaining accumulated GAAP deficit will be funded from appropriations over 13 years, beginning with the FY 2016 budget

KBRA recognizes that the State has actively managed its fiscal pressures in a difficult economic climate and has acted quickly and decisively to restore balanced fiscal operations when needed, as evidenced by actions taken by the Governor and the General Assembly at the end of 2012. Conversion to GAAP-based budgeting and funding of the accumulated GAAP deficit in this biennium has been a priority of the Malloy administration since the Governor took office in January 2011. The FY 2014 - FY 2015 biennium budget represents the first budget to be developed by the State based on GAAP accounting. The State has funded a portion of the accumulated deficit in the General Fund through the issuance of general obligation bonds and will fund the remaining deficit through ongoing appropriations.

After this issuance, total State tax-supported debt will be $19.3 billion consisting of approximately $15.8 billion in general obligation debt and $3.5 billion in special tax debt, which represents a slight increase since last year. The State's direct debt continues to be high, as compared to other states. State tax-supported debt per capita is $5,363 and, tax-supported debt as a percentage of 2014 personal income is 8.8%. The ratio of tax supported debt to 2013 State GDP is 8.6%.

The State continues to operate under a strong framework of financial management policies and procedures. The statutory requirement for the State to monitor and report budget performance on a monthly basis, as well as the requirement that a deficit mitigation plan be developed by the Governor in the event the General Fund deficit exceeds 1.0% of appropriations, has allowed transparency in a time of fiscal pressure.

Based on review of the four KBRA Rating Determinants included in the KBRA Methodology for rating State General Obligation debt, KBRA has determined that the ratings assigned to all of the four Rating Determinants remain consistent with previously designated levels. KBRA continues to assign an overall rating of AA to the State's General Obligation Bonds. KBRA's Rating Determinants and associated rating assessments are summarized as follows:

- Management Structure, Budgeting Practices and Policies: AA+
- Debt and Additional Continuing Obligations: AA-
- Financial Performance and Liquidity Position: AA
- State Resource Base: AA-

Outlook: Stable

The stable outlook reflects KBRA's expectation that the State's leadership will maintain their commitment to fiscal discipline and quickly take all action necessary to maintain budgetary balance. KBRA will continue to monitor the State's consensus revenue process and its ability to accurately project estimates of income tax revenues related to the realization of capital gains and other economically sensitive revenues. KBRA continues to view Connecticut's lagging recovery, compared to the New England region and the US, as putting pressure on State fiscal operations. Though the risk of the federal sequestration program impacting Connecticut's defense contractors has been somewhat mitigated by the passage of a federal budget bill in January 2014, KBRA will continue to monitor the impact of the wind-down of the wars in Iraq and Afghanistan and any impact on the State's economy and finances.

In KBRA's view, the following factors may contribute to a rating upgrade:

- Several years of structurally balanced budgets and actual results showing General Fund operating surpluses.
- Restoration of the Budget Reserve Fund to a level equal to 10.0% of annual expenditures (State statutory Budget Reserve Fund target).
- Significant increase in the funded ratios for the State's pension systems.

In KBRA's view, the following factors may contribute to a downgrade of the rating:

- Continued slower than expected economic recovery which causes revenues, such as personal income taxes and sales taxes, to decline and puts pressure on the General Fund.
- Failure to take actions necessary to maintain budget discipline and balanced financial operations.
- Significant reliance on non-recurring revenues to balance the budget.
- Failure to appropriate necessary funds over time as part of an implementation plan for funding long-term liabilities related to accumulated GAAP deficits and pension liabilities.
- Cuts in federal spending for defense that causes significant contraction in the State's defense related industries.

Financial Performance and Liquidity Position

FY 2014 Financial Operations

Based on the budgetary estimates provided by the State's Office of Policy and Management (OPM) on July 25, 2014 for the period ending June 30, 2014, the State's General Fund is projected to end FY 2014 with a surplus of $121.3 million, or approximately 1% of projected FY 2014 General Fund expenditures, which is higher than the surplus of $43.4 million projected at the time of KBRA's rating report dated June 3, 2014. This consensus revenue forecast reflects the unanticipated slowdown in economic growth during the beginning of 2014. Projected results incorporate the State's transition to budgeting on a GAAP basis and reflect GAAP accounting principles. Pursuant to current state statute, the operating surplus of $121.3 million will be deposited to the Budget Reserve Fund, bringing the estimated balance to $392 million or approximately 2% of projected FY 2014 General Fund expenditures, based on the April 30 consensus revenue forecast. Based on the July OPM report, the increase in the projected surplus is a result of a projected net increase in General Fund revenues, including Federal Grants and personal income tax collections, as well as projected lapses in appropriations.

The Office of the State Comptroller released the FY 2013 audited financial statement (CAFR) reported on a GAAP basis on February 28, 2014. For FY 2013, the General Fund ended the year with a surplus on a GAAP basis of $322.0 million and a negative unassigned fund balance (accumulated GAAP deficit) of $1.2 billion. In October of 2013, the State issued $560 million in GAAP Conversion Bonds that will amortize over 15 years, beginning in FY 2016. Net proceeds of these Bonds were deposited into the General Fund and will fund approximately 50% of the accumulated GAAP deficit and improve the State's cash position. The effect of this deposit was to reduce the negative unassigned fund balance to approximately $618 million. The remaining accumulated GAAP deficit will be funded from appropriations over 13 years, beginning with the FY 2016 budget.

The table below shows the results of General Fund operations on a budgetary basis from FY 2009 to FY 2013.

Statement of Revenues, Expenditures, and Net Surplus for General Fund FY 2009-FY 2013 (modified cash/budgetary basis)					
(in millions)	**2013** [5]	**2012**	**2011**	**2010**	**2009**
Net Surplus July 1st	0	0	0	-947.6	0
Proceeds of Economic Recovery Notes				947.6	
Operating Revenues	19,405.90	18,561.60	17,604.30	16,410.00	15,700.80
Operating Expenditures	19,025.80	18,781.60	17,845.10	17,208.00	17,234.90
Other	18.7	76.5	-75.3	-30.6	586.5
Net Operating Surplus (Deficit)	398.8	-143.6	-316.1	-828.6	-947.6
Transfer (to) from Budget Reserve Fund	-178	143.60 [4]	103.2	1,278.50	0
Reserved for Subsequent Years Expenditure	220.8			449.90 [2]	
Reserved from Prior Year			449.9		
Net Surplus (Deficit) June 30th	**$0**	**$0**	**236.90** [3]	**$0**	**($947.6)** [1]
Source: Connecticut 2013 Official Statement					

[1] FY 2009 net deficit funded by Economic Recovery Notes (2009 Series A) issued in FY 2010.
[2] FY 2010 net surplus was $449.9 million after transfer of Budget Reserve Fund. This amount reserved for FY 2011 operations.
[3] In FY 2011, $14.5 million of the surplus will be deposited in the OPEB Trust Fund and $222.4 million was transferred to the Budget Reserve Fund.
[4] The FY 2012 operating deficit was funded by a transfer from the Budget Reserve Fund, leaving a remaining balance of $93.4 million.
[5] Final Budgetary Basis FY 2013 results. Balance in Budget Reserve Fund is $271.5 million at end of FY 2013.

FY 2015 Budget

The April 30 revenue estimates for the FY 2015 budget, including personal income tax and sales tax, were also revised downward from the January 2014 consensus revenue estimates. As part of the midterm budget adjustment process, the FY 2015 budget has been balanced by reducing budgeted spending, transferring available balances from certain state funds and scaling back on certain proposed tax cuts for FY 2015. OPM is projecting a budget surplus of $400,000 at the end of FY 2015, as compared to the original projection of a $3.1 million budget surplus. After current budget, modifications, FY 2015 General Fund expenditures will increase 2% from FY 2014 levels. The biennium budget includes the use of $190.8 million and $30.0 million of the FY 2013 surplus in FY 2014 and FY 2015, respectively, but overall, reflected a somewhat reduced dependence on one-time revenues, compared with prior years. KBRA will continue to monitor the State's consensus revenue process and its ability to accurately project estimates of income tax revenues related to the realization of capital gains and other economically sensitive revenues.

Liquidity Position

The State's liquidity position is good and continues to improve. The cash position was improved even further with the deposit of the proceeds of the GAAP Conversion Bonds in October of 2013. For FY 2014 the State's available cash averaged $2.0 billion and the common cash pool averaged approximately $790 million on a weekly basis. The common cash pool represents cash resources directly available on a daily basis to fund State operations. Available cash includes bond funds and other balances which can be made available to the common cash pool through temporary transfers under long established state practice. In December 2012, the State secured a $300 million line of credit with a single bank to provide a source of additional liquidity, if needed. In December 2013, the State allowed this facility to expire, without a draw or payment of fees. The State has no plans to issue cash flow notes.

State Resource Base

The State's economic recovery is continuing, though at a slower rate than New England and the US, as evidenced by the lag in job recovery from recession levels and slow job growth in the State's key employment sectors. The State has been in economic recovery since February 2010 and, as of June 2014, has recovered 76% of the total non-farm jobs lost in the recession which improved from the 72% recorded in December 2013. Connecticut's recovery rate remains lower than New England and the U.S.'s recovery rate of 109% and 111%, which improved from 90% and 97% as recorded in December 2013, respectively.

The Recessions Effects on the State of Connecticut's Employment Sectors

(in thousands)	Connecticut Jobs Lost Mar '08-Feb '10	% of Total Non-Farm Jobs Lost	Connecticut Jobs Recovered Since Feb '10	% of Total Non-Farm Jobs Recovered
Services	(35.8)	-23.0%	34.7	29.4%
Manufacturing	(25.4)	-16.3%	(0.1)	-0.1%
Trade	(21.0)	-13.5%	12.8	10.8%
Construction	(24.1)	-15.5%	13.8	11.7%
Financial Activities	(11.2)	-7.2%	(3.2)	-2.7%
Leisure and Hospitality	(26.8)	-17.2%	40.7	34.4%
Government	(6.5)	-4.2%	(9.3)	-7.9%
Information	(6.8)	-4.4%	0.0	0.0%
Transportation and Utilities	(4.9)	-3.2%	6.2	5.2%
Mining and Logging	(0.3)	-0.2%	0.1	0.1%
Education and Health Services	7.4	4.8%	22.5	19.0%
Total Non-Farm	**Jobs Lost** 155.4	**100.0%**	**Jobs Recovered** 118.2	**100.0%**
Job Recovery Rate	**76%**			

Source: U.S. Bureau of Labor Statistics

**Jobs lost is defined as Employment Peak minus Employment Trough*

**Jobs recovered is defined as Current Employment level minus Employment Trough*

**Connecticut Employment Peak Jun 08* **Connecticut Employment Trough Jan 10*

The sectors contributing the most to the State's job recovery are leisure and hospitality for 34.4% as of June 2014, followed by services at 29.4%, and education and health services at 19%. Connecticut continues to struggle with recovery of finance, manufacturing and government sector jobs. Since the end of the recession in February 2010, the state has continued losing jobs in these sectors, with the financial sector declining 2.7% and the manufacturing sector declining 0.1%. This compares to growth in these sectors in the U.S. overall of 4.3% and 7.4% respectively. Government sector employment in Connecticut mirrors the U.S. both declined 4.6% since from February 2010 to June 2014.

Employment and Unemployment Rates

From June 2013 to June 2014, the State has added 9,200 non-farm jobs, which is less than the 22,500 non-farm jobs the State added from June 2012 to June 2013. Connecticut continues trending behind the U.S. and New England employment growth rates. From June 2013 to June 2014, Connecticut employment grew 0.6% compared to 1.3% for New England and 1.9% for the U.S.

Non-Agricultural Employment						
	Connecticut		New England		U.S.	
in thousand	Employment	% Chg.	Employment	% Chg.	Employment	% Chg.
2008	1,699	0.05%	7,065	0.03%	137,170	-0.56%
2009	1,627	-4.26%	6,813	-3.57%	131,233	-4.33%
2010	1,608	-1.14%	6,800	-0.19%	130,275	-0.73%
2011	1,625	1.06%	6,866	0.97%	131,842	1.20%
2012	1,640	0.94%	6,953	1.26%	134,104	1.72%
2013	1,655	0.87%	7,029	1.10%	136,368	1.69%
2014*	1,687	1.97%	7,222	2.73%	139,761	2.49%

Source: U.S. Bureau of Labor Statistics

** Preliminary as of June 2014*

The State had a 2013 unemployment rate of 7.8% compared to the U.S. and New England unemployment rates of 7.4% and 7.1% respectively during the same time period. Declining unemployment rates continue into 2014 with Connecticut's preliminary June 2014 unemployment rate coming in at 6.7% compared to the 6.1% and 5.7% for the U.S. and New England, respectively.

Unemployment Rates (Seasonally Adjusted)			
Year	Connecticut	New England	U.S.
2007	4.6%	4.5%	4.6%
2008	5.6%	5.4%	5.8%
2009	8.2%	8.1%	9.3%
2010	9.3%	8.5%	9.6%
2011	8.9%	7.8%	8.9%
2012	8.3%	7.2%	8.1%
2013	7.8%	7.1%	7.4%
Jun 2014*	6.7%	5.7%	6.1%

Source; U.S. Bureau of Labor Statistics

** preliminary*

Personal Income

Connecticut remains the wealthiest state in the nation as measured by per capita personal income of $61,679 which is 137% of the national average as of the fourth quarter of 2013. Connecticut's personal income continues to improve, growing 0.84% from 3Q2013 to 4Q2013 compared to the US growth rate of 0.55% and the regional rate of 0.86%.

Conclusion

KBRA has assigned an AA rating with a stable outlook to the State of Connecticut general obligation debt based on the factors discussed above.

KBRA LONG-TERM RATING: AA
OUTLOOK: STABLE
Appendix 1: Tear Sheet

Issuance

$510.59 million General Obligation Bonds 2014 Series E and 2014 Taxable Series A & B. KBRA's most recent rating report for the State was published on July 30, 2014.

Security

The Bonds are general obligations of the State and are secured by its full faith and credit pledge.

Use of Proceeds

Proceeds from the 2014 Series E and 2014 Taxable Series A & B will be used to fund various capital projects and purposes of the State.

Key Rating Strengths
Current leadership has demonstrated an ability and willingness to raise revenues and adjust expenditures.
A strong financial management framework exists for tracking revenues and monitoring budget performance.
The State has implemented a plan for funding its accumulated GAAP deficit and converting to GAAP based budgeting as part of the FY 2014- FY 2015 Biennium Budget.
Connecticut has the highest per capita income in the country at $61,679 as of the fourth quarter of 2013.
Available cash balances provide good liquidity for operations, without utilization of external borrowing.

Key Rating Concerns
Slower than expected economic recovery continues to impact revenue collection, threatening budget balance.
Revenue base is volatile due to concentration in the financial services sector and progressive nature of the income tax structure.
Though the State is expecting to increase the Budget Reserve Fund to an amount equal to 2% of General Fund expenditures by the end of FY 2014, this level of reserves remains somewhat low, given the relative volatility of the revenue base.
State debt burden is high on a per capita basis and as a percentage of personal income.
Connecticut has a high level of unfunded pension liabilities.

KBRA views the State's ongoing lag in economic recovery and its impact on budgetary operations as continuing to pressure the fiscal operations of the State. The slow pace of the economic recovery, compared to the region and the nation, has created increased demand for services while some economically sensitive revenue collections, including income tax and sales tax collections, continue to be below expectations. KBRA will continue to monitor the State's consensus revenue process and its ability to accurately project estimates of income tax revenues related to the realization of capital gains and other economically sensitive revenues. KBRA expects that the State will continue to actively monitor its budget projections and act to increase revenues or reduce expenditures in order to maintain budget balance.

Based on the budgetary estimates provided by the State's Office of Policy and Management (OPM) on July 25, 2014 for the period ending June 30, 2014, the State's General Fund is projected to end FY 2014 with a surplus of $121.3 million, or approximately 1% of projected FY 2014 General Fund expenditures, which is higher than the surplus of $43.4 million projected at the time of KBRA's rating report dated, June 3, 2014. This consensus revenue forecast reflects the unanticipated slowdown in economic growth during the beginning of 2014. Pursuant to current state statute, the operating surplus of $121.3 million will be deposited to the Budget

Reserve Fund, bringing the estimated balance to $392 million or approximately 2% of projected FY 2014 General Fund expenditures. Based on the July OPM report, the increase in the projected surplus is a result of a projected net increase in General Fund revenues, including Federal Grants and personal income tax collections, as well as projected lapses in appropriations.

The Office of the State Comptroller released the FY 2013 audited financial statement (CAFR) reported on a GAAP basis on February 28, 2014. For FY 2013, the General Fund ended the year with a surplus on a GAAP basis of $322.0 million and a negative unassigned fund balance (accumulated GAAP deficit) of $1.2 billion. In October of 2013, the State issued $560 million in GAAP Conversion Bonds that will amortize over 15 years, beginning in FY 2016. Net proceeds of these Bonds were deposited into the General Fund and will fund approximately 50% of the accumulated GAAP deficit and improve the State's cash position. The effect of this deposit was to reduce the negative unassigned fund balance to approximately $618 million. The remaining accumulated GAAP deficit will be funded from appropriations over 13 years, beginning with the FY 2016 budget

KBRA recognizes that the State has actively managed its fiscal pressures in a difficult economic climate and has acted quickly and decisively to restore balanced fiscal operations when needed, as evidenced by actions taken by the Governor and the General Assembly at the end of 2012. Conversion to GAAP-based budgeting and funding of the accumulated GAAP deficit in this biennium has been a priority of the Malloy administration since the Governor took office in January 2011. The FY 2014 - FY 2015 biennium budget represents the first budget to be developed by the State based on GAAP accounting. The State has funded a portion of the accumulated deficit in the General Fund through the issuance of general obligation bonds and will fund the remaining deficit through ongoing appropriations.

After this issuance, total State tax-supported debt will be $19.3 billion consisting of approximately $15.8 billion in general obligation debt and $3.5 billion in special tax debt, which represents a slight increase since last year. The State's direct debt continues to be high, as compared to other states. State tax-supported debt per capita is $5,363 and, tax-supported debt as a percentage of 2014 personal income is 8.8%. The ratio of tax supported debt to 2013 State GDP is 8.6%.

Based on review of the four KBRA Rating Determinants included in the KBRA Methodology for rating State General Obligation debt, KBRA has determined that the ratings assigned to all of the four Rating Determinants remain consistent with previously designated levels. KBRA continues to assign an overall rating of AA to the State's General Obligation Bonds.

Outlook: Stable

The stable outlook reflects KBRA's expectation that the State's leadership will maintain their commitment to fiscal discipline and quickly take all action necessary to maintain budgetary balance. KBRA will continue to monitor the State's consensus revenue process and its ability to accurately project estimates of income tax revenues related to the realization of capital gains and other economically sensitive revenues. KBRA continues to view Connecticut's lagging recovery, compared to the New England region and the US, as putting pressure on State fiscal operations. Though the risk of the federal sequestration program impacting Connecticut's defense contractors has been somewhat mitigated by the passage of a federal budget bill in January 2014, KBRA will continue to monitor the impact of the wind-down of the wars in Iraq and Afghanistan and any impact on the State's economy and finances.

Analytical Contacts:

Kate Hackett, Managing Director
khackett@kbra.com, 646-731-2304

Alice Cheng, Senior Analyst
acheng@kbra.com, 646-731-2403